When Mr. Market Gets Depressed, Back Up the Truck …

by Mohnish Pabrai

When the world is shaken up by unexpected geo-political events, investor confidence suffers. But can one person's fear of a volatile environment, be another's long term gain?

After closing in the aftermath of the September 11 tragedy, stocks plummeted the following week — with the Dow over 14%! As one would expect of a rational market, companies like American Airlines, Smith & Wollensky Restaurants, and The Four Seasons Hotels all took major hits to their pre-Sept. 11 market caps. However another important event took place. Federal Reserve Board Chairman Alan Greenspan reduced interest rates by another 0.5 percent, bringing the prime rate to a seven-year low.

As amazing as it sounds, there are a set of businesses for which both the WTC tragedy and Greenspan's rate cut are positive events. Under the rational/efficient market hypothesis, these stocks should have gone up when the markets reopened on the 17th. Is that what happened?

Let's examine a few of these publicly-traded companies. Stewart Enterprises (STEI) is the second largest company in the "deathcare" industry worldwide. Stewart has about $700 million in annual revenues and owns about 700 cemeteries and funeral homes in nine countries, with the bulk of them in the United States. With $325 million in debt tied to the prime lending rate, Greenspan's action will increase Stewart's earnings by about two cents annually.

As a result of the events of Sept. 11, their revenue or operating profit are not expected to *decline* at all (they may have increased). Thus, net-net STEI should have had a price increase of at least $0.20 over its Sept. 10 close. Stewart closed at $7.15 on Sept. 10 and at $5.85 on Sept. 24. In percentage terms, the Dow was down 14 percent during the week, while Stewart was down more than 18 percent! Nearly every single Dow stock is going to report significantly lower earnings as a result, while Stewart will be reporting higher earnings, yet it lost nearly a fifth of its market cap. How much sense does this make?

Let's move from the morbid subject of death to the relatively more uplifting subject of medical diagnostic services. Radiologix (RGX) is a company that develops and manages radiology and medical imaging centers. RGX operates 124 centers in 18 states. The company has about $250 million in annual revenue and a market cap of $121 million ($6.20 a share) as of Sept. 10. In addition, the company has $160 million of debt that is tied to the Fed discount rate and LIBOR. The 0.5 percent drop in interest rates had the impact of increasing EPS

by about $0.05 annually and should have led to a $0.30-0.60 increase in the share price. On Sept. 24, after a steady decline throughout the week, RGX ended at $5.25 — a decline of more than 15 percent!

I cannot find correlation between the events of Sept. 11 and the intrinsic value of RGX. Why did RGX lose 15 percent of its market value in the week following Sept. 11, when it should have increased five to 10 percent?

From death and MRIs, let's move to the more colorful world of retail. Liquidation World (www.liquidationworld.com; LIQWF) is an impressive operation based in Calgary, Alberta, Canada. From its start in 1987 through 2000, sales have grown from less than C$1 million to C$165 million, with no decline in sales in any single year. Since 1992, net profit has grown every single year and they have about 90 stores (up from one in 1987). The company specializes in buying merchandise from other retailers and e-tailers that have obsolete or excess inventory, bankruptcy or distressed situations, receiverships, closeouts, etc. They go in and buy great stuff at pennies on the dollar and then put it in their outlets and do what Sam Walton preached: "Stack it High and Let it Fly!" You get the picture.

When Silicon Valley was reeling from its dot-com bust and all the e-tailers were going under, Liquidation World had many teams working overtime in California and all over the U.S. getting the best stuff from these e-tailers at super-distressed prices. All of those VC losses were their gain!

On Sept. 10, LIQWF was changing hands at around $6 a share. In the wake of the tragedy, it dropped to $5.30 — a 12 percent decline. LIQWF's prospects for picking up excess inventory, etc., only improved after the tragedy as several retailers are driven to the brink of bankruptcy with declining sales and consumer confidence. In addition, most of its outlets are in Canada. Canadians feel significantly less threatened and traumatized than the general U.S. population by the events of Sept. 11. So, the best that I can tell, Liquidation's prospects and profitability only improved. Why did it lose 12 percent of its already modest value?

The public equities markets are mostly efficient, but not fully efficient. Events like Sept. 11 tend to widen the efficiency gap – as shown by our three examples. In times like these, Mr. Market gets severely depressed and can only think about doom, gloom and uncertainty.

Investors who use times likes these to make investments in a few great businesses and make these investments meaningful portions of their portfolio for the long haul can take advantage of these inefficiencies. With his occasional mood swings, Mr. Market offers a wide array of great businesses on "clearance

sale" for a few weeks every few years. This is a good time to take advantage of Mr. Market.

Disclaimer: The companies mentioned in this article are not being highlighted as stock tips or "buys." They may or may not be bargains at current prices. The Pabrai Investment Funds may have present or past long positions in some of the securities mentioned.

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